

The Texas Treasury Safekeeping Trust Company, the Texas Guaranteed Tuition Plan, and the Texas Local Government Investment Pool

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Overall Conclusion

During this audit, we followed up on recommendations we made in 2001 to strengthen the operations of the Texas Treasury Safekeeping Trust Company (Trust Company), the Texas Guaranteed Tuition Plan (Plan, formerly the Texas Tomorrow Fund), and the Texas Local Government Investment Pool (TexPool). We also pursued additional objectives to audit (1) specific aspects of the Plan actuarial assumptions, asset management, and payment timeliness and accuracy and (2) the Plan's and the Trust Company's contract management processes. Overall, we found that:

- The Trust Company has fully or partially implemented all of our 2001 recommendations, many of which were aimed at establishing basic building blocks through the consideration of industry standards.

While the Trust Company has strengthened its organizational structure, staffing, and internal controls, it still needs to fully implement outstanding 2001 recommendations. Most importantly, it needs to fully implement outstanding recommendations through its implementation of new automated systems. As it continues modifying its structure and processes, other necessary improvements have been identified and may continue to be identified. For example, the banking examination the Trust Company obtained in response to our 2001 recommendation identified weaknesses in governance and financial integrity. The financial audit the Trust Company obtained in response to our 2001 recommendation identified material weaknesses in segregation of duties and accounting reconciliations.

- The Plan has fully or partially implemented most of our 2001 recommendations, but it still needs to fully implement outstanding 2001 recommendations. Most importantly, it needs to implement outstanding recommendations to obtain formal research on investment rate of return assumptions and broaden the range of sensitivity testing in its actuarial reports. It should also be noted that the Plan's financial health has declined since our 2001 audit. Much of the decline in the Plan's financial health can be attributed to conditions in financial markets. In addition, the effect of tuition deregulation on the

Background Information

Our audit focused on the following units within the Office of the Comptroller of Public Accounts (Comptroller):

- The Texas Treasury Safekeeping Trust Company (Trust Company) (1) provides a means for the Comptroller to obtain direct access to services provided by the Federal Reserve System and (2) enables the Comptroller to manage, disburse, transfer, protect, and invest funds and securities. As of December 31, 2002, the Trust Company managed \$16.5 billion in assets.
- The Texas Guaranteed Tuition Plan (Plan, formerly the Texas Tomorrow Fund) is a prepaid college tuition program. The Plan is overseen by the Texas Prepaid Higher Education Tuition Board. As of March 31, 2003, the Plan had \$1.3 billion in total assets.
- The Texas Local Government Investment Pool (TexPool) is a local government investment pool that provides investment services to more than 1,700 communities. As of December 31, 2002, TexPool managed \$13.1 billion in assets.



Plan's financial health is uncertain. As of March 31, 2003, the Plan projected that its liabilities exceeded its assets by \$226 million. Under more conservative investment return assumptions, we estimate that deficit could be \$318 million. The Plan is guaranteed by the State; therefore, if the Plan's financial health does not improve, the State would eventually be required to contribute funds to the Plan.

The Plan's investment return assumptions exceed those of comparable prepaid tuition plans and two state retirement plans; therefore, they should be re-examined. Implementation of certain measures in areas such as decision making and investment policy also would help the Plan to balance the difficult task of managing assets to provide benefits to participants while minimizing future liabilities to the State. The Plan generally disburses tuition payments in an accurate and timely manner.

- Now managed by external vendors overseen by the Trust Company, TexPool has strengthened the oversight of its investment operations and its monitoring of external vendors by implementing all of our 2001 recommendations.
- The Trust Company did not consistently follow formal policies and procedures designed to ensure that it fairly and objectively awards contracts to external investment managers. The Trust Company and the Plan also lack formal policies and procedures for monitoring contracts. In addition, unlike other state investing entities, the Plan lacks a policy requiring the members of the Texas Prepaid Higher Education Board (Board) and key employees to disclose conflicts of interest regarding potential contractors.

Key Points

The banking examination and financial audit the Trust Company obtained in response to our 2001 recommendations identified significant weaknesses.

In its recent examination of the Trust Company, the Department of Banking made recommendations to strengthen the Trust Company's governance structure and financial integrity. (Some of those recommendations were similar to recommendations we made in 2001.) The banking examination report recommended that the Trust Company file new articles of incorporation to enhance its legal separation from the Comptroller of Public Accounts, strictly follow the Statement of Principles of Trust Management, and segregate corporate cash and investments from fiduciary assets. Based on its legal interpretation, Trust Company management disagreed with many of the banking examination report's recommendations.

The financial opinion audit that the Trust Company obtained identified material weaknesses in the Trust Company's segregation of duties and in its reconciliations of its general ledger. Material weaknesses are generally serious matters that could lead to the undetected misstatement of amounts in financial statements.

The Trust Company is implementing new automated accounting and investment systems that will help it to implement our prior recommendations.

Because the Trust Company's new accounting and investment systems are still under development, a final determination of their capacity to enable the Trust Company to fully

implement the remainder of our 2001 recommendations cannot be made at this time. We plan to follow up on the implementation of these systems at a later date.

The Plan's investment return assumptions exceed those of comparable plans and two state retirement plans.

The Plan's investment return assumptions are higher than those of (1) most comparable prepaid tuition programs in other states and (2) Texas's two largest state retirement systems. Using an investment return assumption that is too optimistic can lead to the understatement of the Plan's deficit and inaccurate pricing of prepaid tuition contracts. In May 2003, the Plan's investment consultant recommended that the Plan reduce its investment return assumption, but the Board has not yet taken any action on that recommendation.

The Plan lacks certain measures that would help it manage assets to provide benefits to participants while minimizing future liabilities to the State.

Balancing the dual goals of providing benefits to participants and minimizing future liabilities to the State can be a difficult task, and achieving the proper balance between these goals is a complex challenge. Addressing the following issues would both help the Plan to manage this challenge and strengthen the Board's fiduciary role:

- The Board does not always formally vote when making significant decisions. In June 2003, the Board discussed suspending the enrollment of new participants (except for newborns) in the Plan, but it did not formally vote on this decision. In addition, enrollment in the Plan was suspended without determining the actuarial consequences this action could have.
- The Plan's investment consultant does not provide the Board with information on the sources of investment overperformance or underperformance, portfolio turnover, best execution of trades, and investment-style analyses.
- The Plan's investment policy does not specify (1) whether money managers can make soft dollar arrangements, (2) standards to emphasize safety and liquidity over investment yield and standards for credit ratings or collateralization requirements for investments, and (3) a formal and detailed policy for investment manager review and retention.
- The Plan has not defined certain financial terms such as "actuarially unsound" or "financially infeasible." Without these definitions, it is not possible to determine when or if corrective action needs to be taken to strengthen the financial soundness of the Plan.

The Plan also should consider expanding its staff's investment expertise and using passive asset managers.

Summary of Management's Response and Auditor's Follow-up Comment

Management generally agrees with the recommendations in this report, with the exception of its response to the recommendations regarding the Trust Company's banking examination. Management's full responses are presented in Appendix 4. Certain items in management's responses required clarification; therefore, we have also included auditor follow-up comments in Appendix 4.

Summary of Information Technology Review

As discussed previously, the Trust Company is implementing new automated systems for its accounting and investment functions. Although we did not conduct a comprehensive review of information systems, we identified weaknesses in password administration and access authorization in the Trust Company's present investment accounting system. In addition, the management letter that the Trust Company's external auditor prepared noted that the Trust Company lacks written disaster recovery plans that are tested and updated at least annually.

Summary of Objectives, Scope, and Methodology

Our primary objective was to determine whether the Trust Company, the Plan, and TexPool have implemented recommendations we made in 2001. For the Plan only, additional objectives were to determine:

- Whether the Board has adopted actuarial assumptions that are consistent with other states' programs and reasonable when compared with other programs dealing with long-term liabilities.
- Whether the Plan manages its assets to provide benefits to participants while minimizing future liabilities to the State.
- Whether the Plan disburses tuition payments to universities and makes refunds to contract purchasers in an accurate and timely manner.

We also determined whether the Plan and Trust Company have established adequate controls over their contract management processes.

Our scope primarily covered fiscal year 2002. Our methodology consisted of gathering information through interviews; reviewing policies and procedures; testing controls and related documentation; reviewing information technology on a limited basis; attending selected Board meetings; comparing the Plan with Texas pension plans and endowment funds and other states' prepaid tuition plans; and reviewing the Trust Company's banking examination report, financial audit report, and related working papers.

Table of Results and Recommendations

 denotes entry is related to information technology

The Trust Company fully or partially implemented all of our 2001 recommendations, but it needs to fully implement important recommendations that remain outstanding. (Page 1)

The Trust Company should complete the implementation of all 2001 recommendations that it has not fully implemented. (See Appendix 2 for a complete list of those recommendations.)

The Department of Banking's examination identified weaknesses in the Trust Company's governance and financial integrity. (Page 2)

We acknowledge the Trust Company's position regarding the banking examination report (particularly in light of its current governing statute) but encourage it to consider the report's recommendations.

The financial opinion audit the Trust Company obtained identified material weaknesses in segregation of duties and timeliness of reconciliations. (Page 4)

The Trust Company should:

- Correct all weaknesses noted in the financial audit report.
- Ensure that the results of financial audits are issued in a timely manner and promptly share those results with the Trust Company's Investment Advisory Board.

 The Trust Company is developing new accounting and investment systems to strengthen its operations. (Page 5)

The Trust Company should:

- Continue working to implement its new financial accounting and investment accounting systems.
- Monitor to ensure that the new investment accounting system fulfills business and functional requirements.
- Correct the password and access authorization weaknesses in the current investment accounting system and ensure that they are not duplicated in the new financial accounting and investment accounting systems. Specifically, the Trust Company should:
 - ◆ Implement a process requiring users to change their passwords on a regular basis and follow the Comptroller's requirements for establishing passwords.
 - ◆ Ensure that user passwords are not available to division security coordinators for viewing. Passwords should be hidden or encrypted.
 - ◆ Ensure that access authorization is documented and fully supported for all users of the investment accounting system.
 - ◆ Periodically review access authorization for all users, including division security coordinators, to ensure that access rights match job duties and responsibilities.

The Plan fully or partially implemented most of our 2001 recommendations, but it needs to address important recommendations that remain outstanding. (Page 8)

The Plan should complete the implementation of all 2001 recommendations that it has not fully implemented. (See Appendix 2 for a complete list of those recommendations.)

The Plan's investment return assumptions are higher than those of most comparable prepaid tuition programs and Texas's two largest state retirement systems. (Page 9)

The Plan should:

- Re-examine its process for developing investment return assumptions to determine why its assumptions are higher than most other states' return assumptions for prepaid tuition plans.
- Work with its investment consultant to ensure that, at least on an annual basis, it receives formal, documented research to develop investment rate of return assumptions.
- Consider the average duration of its liabilities when developing investment return assumptions.

Table of Results and Recommendations

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The Plan lacks certain measures that would help it manage assets to provide benefits to participants while minimizing future liabilities to the State. (Page 11)

The Plan should:

- Ensure that its Board formally votes on significant decisions such as enrollment suspension, program modification, or program termination. In addition, the Plan should obtain actuarial analyses regarding the fiscal impact of any major decisions before making these types of decisions.
- Obtain additional, useful information from its external investment consultant or others, including information about attribution analysis, portfolio turnover, best execution of trades, investment style analysis, and average daily cash balances.
- Enhance its investment policy by:
 - ◆ Specifying provisions governing soft dollar arrangements.
 - ◆ Specifying more protective standards to emphasize safety and liquidity more than investment yield when choosing cash equivalent investments and establishing minimum standards for the credit ratings on investments or collateralization requirements for investments.
 - ◆ Establishing a money manager review and retention policy that includes guidelines for monitoring investment managers' performance.
- Define the phrases "actuarial soundness," "sufficiently actuarially sound," and "financially infeasible" and use them as criteria to determine when corrective action needs to be taken to ensure the financial health of the Plan.
- Consider (1) expanding its staff's investment expertise to better manage or at least monitor its investment programs and (2) the benefits of using passive indexation strategies for the management of a portion of its investment portfolio.

The Plan generally disburses tuition payments in an accurate and timely manner. (Page 13)

(No recommendations)

TexPool strengthened its operations by implementing all of our 2001 recommendations. (Page 14)

(No recommendations)

The Trust Company did not consistently follow contract award procedures. (Page 15)

The Trust Company should follow formal policies and procedures and adhere to established criteria in evaluating proposals and awarding contracts. In particular, it should:

- Abide by the stated minimum criteria for consideration of proposals that potential contractors submit in response to RFPs.
- Separate its procurements to hire investment managers from its investments in alternative assets.
- Document its evaluation of potential contractors' proposals and related deliberations in a manner that adequately explains the basis on which resulting contract award decisions are made.
- Research potential contractors' tax and child support payment histories sufficiently early in the contractor selection process so they can use the results of that research in the evaluation of potential contractors' proposals.

The Trust Company and the Plan lack formal contract monitoring policies and procedures. (Page 16)

The Trust Company and the Plan should:

- Develop and communicate formal policies and procedures for monitoring contractors. These policies and procedures should identify:
 - ◆ The specific monitoring activities to be performed and the frequency with which they should be performed.
 - ◆ How monitoring activities should be performed, including the information sources that should be used.
 - ◆ The individual responsible for performing each monitoring activity.
 - ◆ How monitoring activities should be documented.

Table of Results and Recommendations
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- ◆ How and to whom the results of monitoring should be communicated.
- ◆ How monitoring results should be used, including requirements for subsequent follow-up.
- Conduct monitoring and evaluation of contractors with a frequency that sufficiently supports the continuous management of contracts. Monitoring and evaluation criteria should directly relate to the specific services each contractor provides and the key provisions of each contract.

The Plan lacks a policy requiring Board members and key employees to disclose conflicts of interest regarding potential contractors. (Page 18)

The Plan should develop and implement a formal policy requiring Board members and key employees to disclose any relationships or other conflicts of interest they may have regarding potential contractors.

Recent SAO Work

Number	Product Name	Release Date
02-007	An Audit Report on the State Treasury and Its Trust Company, the Texas Tomorrow Fund, and TexPool	October 2001

Other SAO Products

Number	Product Name	Release Date
03-038	A Legislative Summary Document Regarding the Comptroller of Public Accounts	January 2003